

Office of Chief Counsel
Internal Revenue Service

memorandum

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from: JAMES P. THURSTON
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subject: [REDACTED]
[REDACTED] Restructuring Transaction

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ISSUE

Can the loan used to finance the purchase of the stock of [REDACTED] by [REDACTED] from [REDACTED] be disregarded under the sham transaction doctrine?

FACTS

1. Restructure

[REDACTED] is a U.K. corporation in the [REDACTED]. [REDACTED] holds [REDACTED] business interests in the United States through its U.S. subsidiary [REDACTED]. In [REDACTED] [REDACTED] undertook a restructuring of its United States businesses. As part of the restructuring, [REDACTED] formed [REDACTED], a Delaware partnership. [REDACTED] was to be formed to be the new parent of [REDACTED]'s U.S. subsidiaries. [REDACTED] checked the box to be treated as a corporation for U.S. tax purposes and a partnership for U.K. tax purposes.

[REDACTED]'s U.S. subsidiaries had been held by [REDACTED] ("[REDACTED]"). The stock of [REDACTED] was owned by [REDACTED], a U.K. subsidiary of [REDACTED]. The first step of the restructure was the sale of all of [REDACTED]'s stock by [REDACTED] to [REDACTED] for \$[REDACTED] on [REDACTED]. On the same day, [REDACTED] contributed [REDACTED] percent of the [REDACTED] stock to [REDACTED] lower tier U.K. subsidiaries who in turn contributed the [REDACTED] stock to [REDACTED].

On [REDACTED], [REDACTED] loaned [REDACTED] \$[REDACTED]. [REDACTED] used the funds to acquire the remaining [REDACTED] percent of the [REDACTED] stock from [REDACTED]. After the sale [REDACTED] owned [REDACTED] percent of the [REDACTED] stock. [REDACTED] contributed all of the stock down through [REDACTED] newly formed U.S. subsidiaries, [REDACTED] and [REDACTED].

At the conclusion of the restructuring, [REDACTED] was directly owned by [REDACTED] and the new parent of the U.S. group was [REDACTED].

2. Circular Loan Transaction and Sale

The \$[REDACTED] loan from [REDACTED] to [REDACTED] was effectuated through an "overdraft facility" with [REDACTED] in the U.K. The overdraft facility permitted the circulation of overdraft funds through accounts of [REDACTED] affiliates as long as "net indebtedness" owed the [REDACTED] affiliates under the facility did not exceed [REDACTED] at the end of each day. The \$[REDACTED] loaned to [REDACTED] by [REDACTED] and "paid" to [REDACTED] for the purchase of [REDACTED] percent of the stock of [REDACTED] was effectuated through the [REDACTED] overdraft facility. Funds were transferred from [REDACTED]'s account to [REDACTED]'s account, creating a "loan," and transferred back to [REDACTED]'s account again as sale proceeds at the end of the day with a facility fee due to [REDACTED].

3. Interest Deductions

_____ deducted interest on the \$_____ purported debt in the amount of \$_____ on its tax return for taxable year ended _____.

Discussion

You requested our advice on whether the sham transaction doctrine can be applied to disregard the loan that was used by _____ to purchase the _____ stock from _____. You propose to disregard the purported \$_____ loan made by _____ to _____ and recast the sale of the _____ stock by _____ to _____ as an I.R.C. § 351 contribution of the stock by _____ to _____. You suggest that the only purpose for the loan was to allow _____ the U.K. parent, to strip out U.S. earnings of the _____ group via interest payments deductible by the U.S. group as opposed to non-deductible dividends subject to U.S. withholding. (b)(5)(AC), (b)(5)(AWP)
(b)(7)a _____

Law

The Ninth Circuit applies a two-pronged inquiry to determine whether a transaction is a sham for tax purposes as follows: (1) has the taxpayer shown a business purpose for engaging in the transaction other than tax avoidance? (2) has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits? *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987). The application of the "business purpose" prong is a subjective test, whereas the application of the economic substance prong is an objective test. *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988).

Where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978) *Bass v. Commissioner*, 50 T.C. 595, 600 (1968) ("a taxpayer may adopt any form he desires for the conduct of his business, and . . . the chosen form cannot be ignored merely because it results in a tax saving.").

¹ (b)(5)(AC), (b)(5)(AWP), (b)(7)a _____

However, the form the taxpayer chooses for conducting business that results in tax-avoidance must be a viable business entity, it must have been formed for a substantial business purpose or actually engage in substantive business activity. *Bass*, 50 T.C. at 600.

Business Purpose

The taxpayer has provided a "[REDACTED] (the "Briefing Paper") in response to an IDR concerning the business purpose of the [REDACTED] restructure of [REDACTED]'s U.S. group. The Briefing Paper was prepared by [REDACTED], a U.K. law firm. The Briefing Paper provides that the purpose for the [REDACTED] reorganization of the U.S. group was as follows:

[REDACTED]

(b)(5)(AC), (b)(5)(AWP), (b)(7)a

[REDACTED]

(b)(5)(AC), (b)(5)(AWP), (b)(7)a

[REDACTED]

Economic Substance

(b)(5)(AC), (b)(5)(AWP), (b)(7)a

[REDACTED]

(b)(5)(AC), (b)(5)(AWP), (b)(7)a

(b)(5)(AC), (b)(5)(AWP), (b)(7)a

(b)(5)(AC), (b)(5)(AWP), (b)(7)a

Courts have given great latitude to shareholders in restructuring the form of their investment in a corporation. If the form of the indebtedness is proper and there is an intent to repay the indebtedness on behalf of the corporation, courts are reluctant to challenge the conversion of an investment from equity to debt.

In *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), the Second Circuit reversed a decision by the Tax Court and held that the debentures at issue were bona fide debt, notwithstanding that they were issued by the subsidiary to its parent as a dividend. The Tax Court had found that there was no intent to create a valid debtor-creditor relationship between the taxpayer and its parent and that the so-called interest payments in reality constituted non-deductible dividend distributions. The Second Circuit held that the issuance of the debentures may not be disregarded if in fact the debentures were real, and created legal rights and duties. The debentures were given effect even though their distribution was only partially out of earnings and profits of the distributing subsidiary. A substantial return of capital was also associated with the distribution. *Id.* at 121. See also Treas. Reg. §§ 1.301-1(d)(1)(ii); 1.301-1(h)(2)(i) (contemplating that debt can be distributed to shareholders).

In *Kraft*, the subsidiary received no consideration for the debentures that it issued to its parent. (b)(5)(AC), (b)(5)(AWP), (b)(7)a

Case Law Cited

You have cited several cases in support of applying a sham analysis. However, the cases cited are distinguishable. In *Medieval Times N.V. v. Commissioner*, TC Memo. 1996-455, the Tax

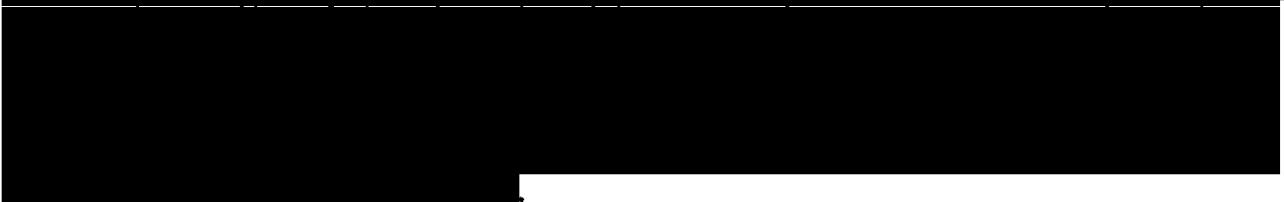
Court examined the claimed deductions of a U.S. group of controlled corporations for payments made to Spanish investors. The payments were based upon the alleged ownership by the Spanish investors of valuable intangibles that were purportedly licensed to the controlled U.S. corporations. The Tax Court determined that the Spanish investors did not own the intangibles in question because they had been developed by the U.S. entities. Accordingly, the purported royalty payments lacked economic substance under section 482 because the Spanish investors were not the creators or developers of the intangibles. As a result, they did not have the ability to transfer intangibles.

In *Medieval*, some of the claimed royalty payments were interest payments on promissory notes issued by the U.S. entities to the Spanish investors in lieu of cash royalty payments. The court determined that the interest payments were not deductible because they were not based upon genuine indebtedness. The court noted the circular flow of funds used to avoid withholding on the interest payments. In addition, the court stated:

Petitioner's attempt to distinguish the instant cases from other circular money movement cases. They argue that, in the instant cases, there is real value underlying the lump-sum royalty payments. Petitioners contend that the real value consisted of the right to use the payee's valuable intangibles for an extended period. As we concluded earlier Manver [the Spanish investor] did not own or transfer the intangibles and, therefore, petitioners could have used the intangibles without paying Manver. Petitioner's have failed to persuade us that we should treat their circular money movements as anything other than shams.

(underscoring supplied)

(b)(5)(AC), (b)(5)(AWP), (b)(7)a



In *Ballantyne v. Commissioner*, TC Memo. 1996-456, the Tax Court found the taxpayer liable for gain on the sale of real property and disallowed interest deductions arising from purported indebtedness found to be a sham. *Ballantyne* involved a complex series of purported real estate transfers and flow of

funds through off-shore entities controlled by the taxpayer. Transfer documents were back-dated. Recordings of the property transfers were inconsistent with Petitioner's claims. The court determined that the purported transfer of property giving rise to the alleged indebtedness by the taxpayer to his corporation was a sham. As a result, the interest deductions were disallowed. The entities and transactions in *Ballantyne* were found to have only a tax avoidance purpose (to achieve a greater basis in the real estate and to generate interest deductions). The real estate transferred was owned by the taxpayer at the beginning of the series of transactions and at the end of the transactions. The corporate entities created and the flow of funds between them were not associated with any legitimate business purpose. In this case, the ownership of the [REDACTED] stock was transferred from [REDACTED] to [REDACTED]. (b)(5)(AC), (b)(5)(AWP), (b)(7)a

[REDACTED]


[REDACTED]

In *Erhard v. Commissioner*, the Ninth Circuit affirmed the Tax Court's disallowance of interest deductions on indebtedness that was found to be a sham. The loans in question followed a convoluted and circular path through a system of entities created to insure that money could be paid offshore in a deductible fashion and return onshore in a non-income fashion. The loans originated with system funds and were repaid with system funds. The court found that there was no economic substance to the loans. (b)(5)(AC), (b)(5)(AWP), (b)(7)a

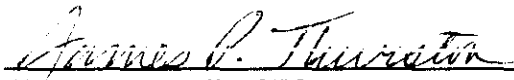
[REDACTED]


[REDACTED]

(b)(5)(AC), (b)(5)(AWP), (b)(7)a



If you have any questions, please call us.


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